**Office of Chief Counsel**
**Internal Revenue Service**

# memorandum

CC:SER:KYT:NAS:TL-N-3267-99
HPLevine, ID# 62-09574

VIA E-MAIL AND US MAIL

date: JUL 23 1999

to: International Examiner Danny K. Horner
P.O. Box 38443
Germantown, TN 38183-0443

from: District Counsel, Kentucky-Tennessee District, Nashville

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subject: [redacted]
Applicability of I.R.C. § 367

This is to follow-up on our July 8, 1999 memorandum. We requested that the National Office review the advice that we provided, and they have provided us with the following insightful comments and suggestions:

- It appears that the transaction was consummated during [redacted], based on the tax advice letter, valuation and the reporting by [redacted] for its fiscal year ending [redacted]. Therefore, the temporary regulations under Treas. Reg. § 1.367(a)-3T(c) apply. Although there are no technical differences, reference should be made to the correct applicable regulations. The temporary regulations superceded Notice 94-46. These references were on page 3 of our memorandum.

- We have been advised that a substance over form test is not applied in the I.R.C. § 367 area. See the reference on page 4 of our memorandum. Rather the substance test has been replaced by a pure technical form test, involving a strict analysis of the voting power and the value of the stock. The I.R.C. § 318 constructive ownership rules apply in determining voting power and the stock value, which is based solely on interests greater than 50%, and not on effective control or ownership (such as would be the case if coalitions of stockholders were formed). The amount of the stock that [redacted] received based on the [redacted] valuation would not be considered a substance analysis, but a valuation test, and would therefore, remain an appropriate item for inquiry.

- We do not believe that a form test precludes a determination as to whether the transaction was bona fide. See pages 3 and 4 of our memorandum. Nor should it preclude a review of the understanding of the economic substance or business purpose of the transaction since [redacted] may have received taxable consideration other than stock or additional stock through the [redacted] companies which can be attributed to him.

- Whether I.R.C. § 367 ultimately applies however will be determined on whether [redacted] has control or ownership determined on a more than 50% of the value or vote test. See for example, pages 5 and 6 of our memorandum. The statement on page 6 concerning a coalition with the [redacted] companies to achieve majority status no longer applies in the I.R.C. § 367 analysis. However, the relationship between [redacted] and the [redacted] companies may be indicative of a direct or indirect ownership of the [redacted] companies and may support an argument that [redacted] had an ownership interest which under the I.R.C. § 318 attribution rules may be relevant in determining whether I.R.C. § 367 applies.

- To the extent that the I.R.C. § 351 transaction between [redacted] and [redacted] was part of a series of transactions leading to the IPO, the IPO may have further diluted [redacted]'s interests. If the I.R.C. § 351 transaction was an integrated step (similar to a step transaction analysis), then the extent that [redacted] had voting control or a majority of the stock value would be determined after the IPO. This would be relevant if [redacted] issued Treasury stock since additional shares would be issued. This would also be relevant if [redacted] sold some of his stock but the stock sale should be otherwise taxable. It would not be relevant if other shareholders sold stock since the pool of available stock would remain the same, unless [redacted] purchased some of this stock on the open market in which case, his interest may have actually increased.

Please contact the undersigned at (615) 250-5072 if you have any questions. We are leaving our file open to assist you in factual development.

JAMES E. KEETON, JR.
District Counsel

By:
HOWARD P. LEVINE
Senior Attorney

cc: SLA Kim Palmerino (via e-mail)

cc: ARC (TL) Roy Allison (via e-mail)

cc: ARC (LC) Don Williamson (via e-mail)

cc: ADC Nancy Hale (via e-mail)

cc: Bob Lorence (CC:INTL:Br.4) (via e-mail)

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Applicability of I.R.C. § 367

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE:

Whether the Internal Revenue Service should pursue the potential I.R.C. § 367 issue?

CONCLUSION:

The Internal Revenue Service should pursue the potential I.R.C. § 367 issue since the facts do not appear to comport with economic reality and therefore, the transaction may have been a ruse to avoid income tax.

FACTS AND DISCUSSION:

**Facts:**

The taxpayer, [redacted], claims that [redacted] (a/k/a [redacted]), a domestic taxpayer, owned [redacted]% of its stock. [redacted], allegedly owned by [redacted]'s brother, a non-United States person, allegedly owned the other [redacted]%. In simple terms, the stock of [redacted]'s and [redacted] were transferred to a newly created Bermuda entity. Other Singapore entities also allegedly transferred small cash amounts at the same time, which further diluted [redacted]'s interest. These were accomplished under I.R.C. § 351. [redacted] claims to have valued the [redacted]'s and [redacted] stock at the transaction date, finding values of $[redacted] and $[redacted], respectively. The fair market value estimates were in the words of [redacted] "reasonably represented" amounts.

Based on the following factors, [redacted] received less than [redacted]% of the Bermuda (transferee) entity such that the taxpayer claims that I.R.C. § 367 did not apply: (1) [redacted] owned only [redacted]% of [redacted]; (2) the close values between [redacted]'s and [redacted]; (3) a marketability discount of [redacted]% which reduced the value of [redacted]; and (4) the cash provided by the Singapore interests in exchange for [redacted]% and [redacted]% in stock in the Bermuda entity.

[redacted] alleges that [redacted] did not own any of the other interests that received stock in the Bermuda company. The owners of the Singapore companies have not been identified. Although the [redacted] fair market value of [redacted]s and [redacted] differed by only [redacted]%, the balance sheets and income statements show substantial differences. [redacted]'s gross income was $[redacted], while [redacted]'s was approximately $[redacted]. [redacted]'s had taxable income of $[redacted], [redacted] $[redacted], primarily based on non-operating income. [redacted]'s had total assets of $[redacted], while [redacted] had total assets of $[redacted].

The [redacted] [redacted] opinion letter noted that it was their understanding that there had been discussions for a public stock offering (IPO) of [redacted] stock on the Hong Kong or other foreign exchange. SLA Kim Palmerino determined that [redacted] indeed is listed on the Singapore stock exchange, with shares available in the United States through the OTC "pink sheet" market. [redacted] stock was reported down by [redacted]% between the [redacted] to [redacted] period. [redacted] was included in the BT-Singapore Regional Index, a market value-weighted index of 38 stocks. In order to be included, the market capitalization had to be no less than US$200M with at least 30% of their business originating from the Asian region outside of Singapore. According to a recent

article on an unrelated company, [redacted]'s brother, [redacted] was identified as [redacted] of [redacted], which means in all probability that [redacted] is the [redacted].

**General law:**

I.R.C. § 367 disallows corporate status to a transferee in an I.R.C. § 351 transaction where domestic stock is transferred to a foreign corporation. As a result, a tax-free exchange fails. I.R.C. § 367 was enacted as an anti-abuse provision based on a loophole whereby United States taxpayers could transfer tax-free domestic securities with large built-in gains for foreign stock with capital gains avoided if the domestic assets are later sold by the foreign corporation. The Internal Revenue Service in Notice 94-46 and in Treas. Reg. § 1.367(a)-3(c), issued requirements for domestic taxpayers to avoid taxation under I.R.C. § 367. In general, for a domestic taxpayer with greater than a 5% interest, immediate taxation can be avoided if the interest received in the foreign transferee after the exchange is less than 50% by value or vote. The domestic taxpayer must also enter into a 5-year agreement to recognize gain if the foreign corporation disposes of the United States stock within 5 years.

**Possible areas of inquiry:**

There appear to be multiple areas to inquire into in determining whether I.R.C. § 367 applies.

- It is necessary to determine the bona fides of the transaction by reviewing the substance of the transactions in order to determine [redacted]'s true ownership.

- It is not clear why the consolidation occurred at all and especially when it did in [redacted] Because of the transaction, [redacted] lost control of [redacted]. This is unlikely since he started the company and was singularly responsible for its success. Instead of the majority interest in a domestic company, he now purports to own a minority interest in a foreign holding company. Since the stock was sold in an IPO on the Singapore stock exchange, he may have sold some or all of his interest and the transaction may have been consummated for liquidity and marketability purposes.

- The business purpose for the transaction is nowhere stated. Rather, the [redacted] valuation contains a disclaimer that the valuation is for purposes of taxes only and may not be relied upon or disclosed for any

other purpose. It may be prudent to determine the efficiencies of scale sought, product fit and marketplace expansion or other business advantages that could be anticipated through the consolidation.

- It is also not clear how and why [redacted] secured a [redacted]% interest in [redacted]'s or for how much. The consideration paid and the time in which the transactions occurred should be determined. It is possible that dividends were paid to the true owners before and/or after the reorganization. The [redacted]% interest could have been transferred immediately prior to the reorganization, which may have a bearing on the true substance of the ownership. Under the step-transaction doctrine, it may be possible to integrate a series of transactions if they were part of a pre-conceived transaction. Therefore, we suggest that you determine the basis for [redacted]'s [redacted]% interest, including the timing of the transaction and the amount paid. The amount paid if arm's length may also be a better indicator of value than the [redacted] valuation.

- The corporate structure of the transferee entity and adherence to formal indicia of separateness should be investigated. That is, who were the officers of the transferee corporation and [redacted]'s after the transaction. The extent that [redacted] has control of the corporation as CEO or chairman of the board may reflect the extent that he can exercise control. The failure to follow formal prerequisites such as authorizing officers to perform actions and the manner in the operations changed after the transaction may have a bearing.

- The valuation of the [redacted]'s and [redacted] interests should be reviewed. The values appear to be bootstrapped for tax purposes. [redacted] itself indicates that the values are the FMV amounts were "reasonably represented" by the amounts. This type of imprecise language appears to be intentional and may be reflective of the looseness inherent in the valuation.

It appears that the 50% or more voting or value requirement in I.R.C. § 367(a) refers to a substance **and** form standard. Therefore, avenues to explore include determining whether in substance, [redacted] effectively controls the decisions made by [redacted] (Bermuda) or whether the value of the shares he contributed without question, greatly exceed 50% of the combined value of the value of [redacted] on [redacted]. Because of the subjective

nature of valuation issues, it is necessary for the Internal Revenue Service to establish a substantial undervaluation of the [redacted] fair market value. In other words, if the value of [redacted]'s [redacted]% interest was in the range of 50-55% of the total value of [redacted], then there may not be enough room for error to pursue this, since a 10% valuation adjustment would result in a less than 50% interest. However, if we are confident that [redacted]'s [redacted]% interest exceeded, for example, 60% of the value of [redacted], then there would be a greater margin of error.

Alternatively, the Internal Revenue Service may be able to establish that [redacted]'s [redacted]% interest in [redacted] entitles him to share in at least 50% of the equity. To establish this, you may want to determine if there is a side agreement or actual evidence that he receives extraordinary distributions from [redacted] or otherwise receives a share of [redacted]'s profits indirectly from his brother or the other investors. In this regard, the recent news article indicates that [redacted] was the [redacted]. You should determine whether [redacted] is the [redacted] and the extent that he is able to exercise control through this position which affects his stock holdings. Since he is less than a 50% shareholder, assuming that he is the [redacted], support from some of the other minority shareholders would have been required for him to assume this position. Any fees paid to him as a [redacted] officer or director (including [redacted] should be scrutinized to see if they are disguised returns on capital.

We suggest that you focus on the documents and attempt to obtain all of the [redacted] (Bermuda) corporate organizational documents to satisfy yourself that [redacted], in spite of his [redacted]% interest, does not control the Board of Directors. In this regard, we may also want to seek copies of all minutes of the Board of Directors from [redacted] to present. You may also want to ask for [redacted] to obtain detail bank statements of all of [redacted]'s accounts or at least for payments made to [redacted] and [redacted]. The information obtained by SLA Palmerino indicates that the [redacted] is [redacted]'s United States [redacted] bank.

We also suggest that you determine the requirements for Singapore IPOs and whether United States type prospectuses are required. In the IPO, [redacted] either sold its own stock or stock of the key shareholders/officers. It could be that [redacted] sold all or part of his [redacted] stock in the IPO, which he should have reported on his United States income tax return. It may also be that [redacted] purchased stock in the IPO (say from the [redacted] companies). Again, to the extent that some or all of these series of transactions should be integrated as a single transaction may be an issue if for example, [redacted] owned

over 50% of the [redacted] stock acquired in the IPO from the [redacted] companies. In this regard, we suggest that you attempt to determine the [redacted] owners. The extent that these interests can be attributed to [redacted] may have a decisive influence on the applicability of I.R.C. § 367. Since [redacted] was the largest minority shareholder, it would be surprising if he represents that he does not know the [redacted] companies owners since they alone can greatly influence his position by joining with him for a majority interest. To the extent that [redacted] is the [redacted], the support of [redacted] may have been needed. This may also bear on whether the Internal Revenue Service can establish a sufficient relationship between [redacted] and the [redacted] companies to aggregate their interests.

Depending upon the taxpayer's willingness to comply with these factual development requests, the Internal Revenue Service should determine the extent to which formal information gathering provisions, such as under I.R.C. § 982 should be pursued. If [redacted] is a director of the parent [redacted] company, then the Internal Revenue Service should be able to serve him with a domestic summons, it would acquire personal jurisdiction over him and may be able to compel him to produce [redacted] s records. See United States v. Toyota Motor Corporation, 561 F.Supp. 354 (CD Cal. 1983); and United States v. Toyota Motor Corporation, 569 F.Supp. 1158 (CD Cal. 1983).

Please contact the undersigned at (615) 250-5072 if you have any questions. We are leaving our file open to assist you in factual development. Attached are copies of the [redacted] public filing information that was provided to us by SLA Palmerino.

Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you.

JAMES E. KEETON, JR.
District Counsel

By: _____
HOWARD P. LEVINE
Senior Attorney

Attachments:
[redacted] public information
Client-survey

cc: SLA Kim Palmerino (vis e-mail)

cc: ARC (TL) Roy Allison (via e-mail)

cc: ARC (LC) Don Williamson (via e-mail)

cc: ADC Nancy Hale (via e-mail)